

Message Text

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ACTION EUR-12

INFO OCT-01 EA-10 IO-13 ISO-00 AID-05 CIAE-00 COME-00
EB-08 FRB-03 INR-07 NSAE-00 USIA-06 XMB-02
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R 051323Z OCT 77
FM AMEMBASSY LONDON
TO SECSTATE WASHDC 9019
TREASURY DEPT WASHDC
INFO AMEMBASSY BONN
AMEMBASSY PARIS
AMEMBASSY TOKYO
AMEMBASSY BRUSSELS
USMISSION GENEVA

C O N F I D E N T I A L SECTION 01 OF 02 LONDON 16576

USOECN ALSO FOR EMBASSY
USEEC
USMTN

E.O. 11652: GDS
TAGS: EFIN, UK
SUBJECT: HMTREASURY ON UK PRICE AND WAGE OUTLOOK

SUMMARY: HMTREASURY EXPECTS A DECLINE IN THE ANNUAL RATE
OF PRICE INCREASE BY DECEMBER TO ABOUT 12.3 PERCENT AND TO
PERHAPS 10 PERCENT BY MARCH 1978. THEREAFTER, ON BEST
ASSUMPTIONS, HMTREASURY HOPES THAT THE RATE WILL STABIL-
IZE, POSSIBLY FALLING SLIGHTLY FURTHER, PROVIDED THE RISE
IN AVERAGE EARNINGS UNDER PHASE THREE IS HELD TO 11-12
PERCENT. ON THESE ASSUMPTIONS GDP IS EXPECTED TO PICK UP
SHARPLY (4 PERCENT THROUGH 1978) BRINGING WITH IT
ABOVE TREND PRODUCTIVITY INCREASES WITH INCREASED UTILI-
ZATION OF SPARE CAPACITY AND LOWER AVERAGE UNIT COSTS.
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IF AVERAGE EARNINGS EXCEED 12 PERCENT, THE "BEST ASSUMP-
TION" SCENARIO BEGINS TO UNRAVEL. END SUMMARY

1. IN TOUR D'HORIZON OF HMG'S COUNTERINFLATION POLICY,
SENIOR HMTREASURY OFFICIAL RESPONSIBLE FOR COUNTERINFLA-
TION POLICY MADE FOLLOWING POINTS TO FINANCIAL ATTACHE
AND EMBOFF.

A) THE PATTERN OF SETTLEMENTS IN THE CURRENT PAY ROUND WAS CLUSTERING AROUND HMG'S 10 PERCENT EARNINGS GUIDELINE, BUT THE ACTUAL OUTCOME OF THE PAY ROUND WOULD NOT BE KNOWN UNTIL IT WAS CONCLUDED IN MID 1978.

B) SETTLEMENTS IN THE PUBLIC SECTOR WERE IMPORTANT IN INFLUENCING THE SHAPE OF THE PAY ROUND. IT WAS ESSENTIAL THAT CIVIL SERVANTS NOT BE ALLOWED TO CONCLUDE SELF-FINANCING PRODUCTIVITY DEALS, ALTHOUGH THESE WOULD BE REQUIRED IN SOME NATIONALIZED INDUSTRIES

(THE MINERS RECEIVED SPECIAL MENTION) IN ORDER TO GLOSS OVER INCREASES ABOVE 10 PERCENT. THE MILLION LOCAL AUTHORITY MANUAL WORKERS DUE TO SETTLE IN NOVEMBER ARE THE FIRST MAJOR PUBLIC SECTOR GROUP ON THE BARGAINING CALENDAR. PRESS REPORTS OF THEIR BEING ACCORDED A 20 PERCENT PAY INCREASE WERE INCORRECT. HEAVY PRESSURES WERE BEING EXERTED TO HOLD ANY SETTLEMENT BELOW 10 PERCENT; BOTH AS AN EXAMPLE TO OTHER GROUPS AND TO CREATE SOME LEeway FOR ACCORDING OTHER GROUPS SOMEWHAT MORE THAN 10 PCT .

2. PAY ANOMALIES WHICH HAD ARISEN UNDER THE RIGID FIRST TWO YEARS OF INCOMES POLICY WOULD BE DEALT WITH AS FAR AS POSSIBLE BY WHAT WAS DESCRIBED AS THE "ENVELOPE APPROACH". THE CASE OF A SUPERVISOR EARNING LESS THAN HIS IMMEDIATE SUBORDINATE WAS CITED. AN ADDITIONAL PAYMENT TO THIS INDIVIDUAL WOULD APPEAR IN HIS PAY
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ENVELOPE. IT WAS STRESSED THAT SUCH INDIVIDUAL AWARDS WOULD HAVE TO BE WITHIN THE OVERALL SETTLEMENT FIGURE OF 10 PERCENT.

3. TURNING TO THE ECONOMIC OUTLOOK, SOURCE SAID THAT LIKELY INCREASE IN RETAIL PRICES ASSUMING 10-11 PERCENT RISE IN AVERAGE EARNINGS OVER NEXT 12 MONTHS COULD BE ALONG THE FOLLOWING LINES:

BY DECEMBER 1977 -- 12.3 PERCENT

BY MARCH 1978 -- 10.0 PERCENT

FROM THERE THE INDEX COULD EASE A FURTHER POINT OR TWO, TOWARDS 8 PERCENT IF AVERAGE EARNINGS WERE HELD AT 10-11 PERCENT, AND PRODUCTIVITY INCREASED AS SPARE CAPACITY WAS BROUGHT INTO SERVICE AND AVERAGE UNIT COSTS REDUCED. SOURCE DID NOT REALLY EXPECT AVERAGE EARNINGS WOULD HOLD AT 10 PERCENT, BUT HOPEFULLY 11-12 PERCENT WAS POSSIBLE. IF AVERAGE EARNINGS EXCEEDED THIS, THEN OUTLOOK FOR RETAIL PRICE INCREASES WOULD BECOME PROGRESSIVELY LESS FAVORABLE.

4. OUTLOOK FOR GDP IN 1978.

GROWTH OF UP TO 4 PERCENT 1978-IV OVER 1977-IV IS DISTINCT POSSIBILITY, DUE IN LARGE PART TO POSITIVE EXPECTED

GROWTH OF CONSUMER EXPENDITURE AND NET EXPORTS, HOPEFULLY WITHOUT MAJOR OVERHEATING. INDUSTRIAL STRATEGY HAD PRODUCED SOME IMPROVEMENT IN BOTTLENECK SECTORS LIKE FERROUS FOUNDRIES. THE CURRENT ACCOUNT WAS LIKELY TO BE

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BUOYANT IN 1978, ALTHOUGH SOURCE ADMITTED PAST TRENDS IN IMPORT ELASTICITY DURING EXPANSION OF ECONOMY AND GROWTH IN CONSUMER INCOME WOULD BEAR WATCHING, DESPITE BENEFITS OF NORTH SEA OIL TO UK ECONOMY.

5. COMMENT

ASSUMING TWO MODERATE REFLATIONARY PACKAGES IN THE OFFING, ONE IN THE FIRST HALF OF NOVEMBER AND THE SECOND IN THE FY78/79 BUDGET PRESENTATION (LATE MARCH OR EARLY APRIL OF NEXT YEAR), THERE IS A FAIR CHANCE THAT REAL GROWTH FROM NOW TO THE FOURTH QUARTER OF 1978 OVER THE SAME PERIOD THIS YEAR COULD BE IN THE FOUR PERCENT RANGE. THE LIKELIHOOD OF A MARKED IMPROVEMENT IN PRODUCTIVITY AS SPARE CAPACITY IS BROUGHT INTO USE IS MORE PROBLEMATIC, BEARING IN MIND GROSS FIXED INVESTMENT IN MANUFACTURING

INDUSTRY HAS FALLEN IN FOUR OF THE LAST SEVEN
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YEARS (I.E., 1971-1972 AND 1975-1976). THE BRITISH
TREASURY ADMITS THAT IT DOES NOT REALLY KNOW HOW MUCH
SPARE CAPACITY EXISTS IN MANUFACTURING INDUSTRY, BUT
SEEMS HOPEFULLY SANGUINE ABOUT ITS AVAILABILITY TO MEET
INCREASED DEMAND.

6. THE ESTIMATES FOR WAGE AND PRICE PERFORMANCE MUST ALSO
BE VIEWED SKEPTICALLY UNTIL JUSTIFIED BY POSITIVE PERFORM-
ANCE. RECALL THAT PHASE ONE OF THE INCOMES POLICY
(AUGUST 75--JULY 76) INITIALLY PROMULGATED A 6 POUND MAXI-
MUM WAGE INCREASE (10-11 PERCENT RISE IN AVERAGE EARN-
INGS) FOR THOSE EARNING LESS THAN 8,500 POUNDS, WITH NO
INCREASE FOR THOSE EARNING ABOVE THAT FIGURE. THE 6 POUND
MAXIMUM ALSO RAPIDLY BECAME A 6 POUND MINIMUM, WITH AVER-
AGE EARNINGS INCREASING ROUGHLY 14.2 PERCENT IN PHASE ONE,
CONSIDERABLY HIGHER THAN THE INITIAL AIM. PHASE TWO OF
THE INCOMES POLICY HAS BEEN HERALDED AS A SUCCESS, HOLDING
AVERAGE EARNINGS TO 8.8 PERCENT; IT WAS INITIALLY
INTRODUCED WITH THE TARGET FIGURE FOR AVERAGE WAGE
INCREASES OF 4.5 PERCENT (AND WHEN QUESTION-
ED, UK OFFICIALS ADMITTED UNDER THEIR BREATH THAT WAGE
DRIFT MIGHT PERHAPS ADD A FURTHER 2.5 PERCENT). SINCE
THEN, THE TARGETS HAVE BEEN STEADILY REVISED UPWARDS UNTIL
LAST APRIL WHEN THE CHANCELLOR SAID THAT A 10 PERCENT IN-
CREASE WOULD BE CONSIDERED A SUCCESSFUL OUTCOME. IN THAT
LIGHT, THE 8.8 PERCENT RISE LOOKS QUITE FAVORABLE. WE
MUST WISH THE BRITISH WELL IN THEIR VERY GENUINE ENDEAVOR
TO MAINTAIN THE GROWTH OF AVERAGE EARNINGS TO A 10 PERCENT
LEVEL DURING THE THIRD PHASE, BUT WE SHOULD NOT CONFUSE
OUR HOPES FOR THEIR SUCCESS WITH A FIRM EXPECTATION THAT
IT WILL ACTUALLY HAPPEN AS PLANNED.

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